

Tax Restructuring Proposal FY 2008 Budget

House Tax Policy
Committee

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State Treasurer
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Topics Covered

- Revenue picture
- Tax cuts of the 1990s
- MBT changes
- Additional elements of tax proposal

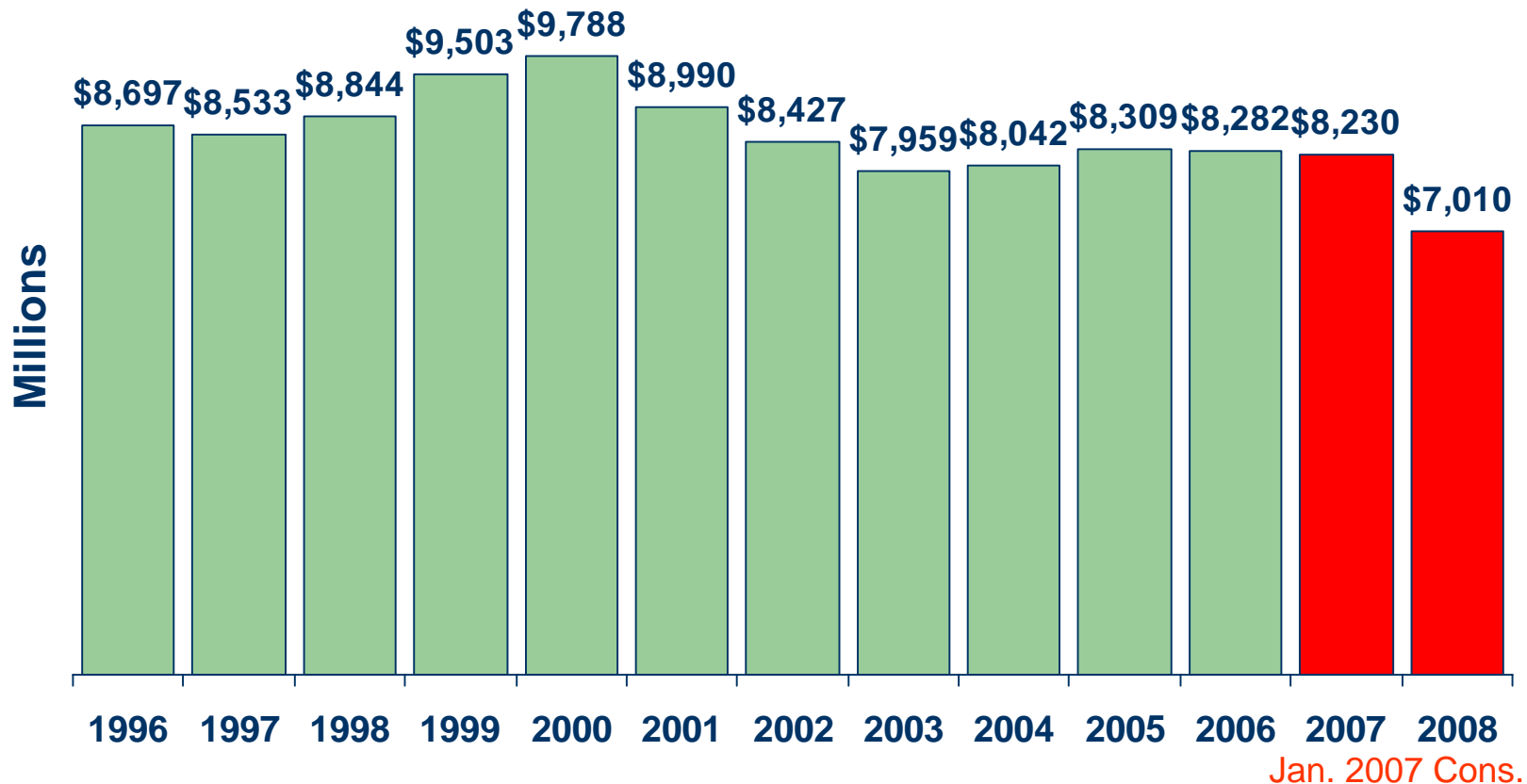
Total State Expenditures

Fiscal Year	Total Expend.	Fed. Aid	Transp.	School Aid	Other Restricted	GF-GP
2001	\$36,953.3	\$10,002.2	\$2,046.7	\$10,401.7	\$4,758.3	\$9,744.4
2006	\$41,264.3	\$12,885.4	\$2,184.1	\$11,682.5	\$5,455.7	\$9,056.6
% Change	12%	29%	7%	12%	15%	-7%
Infl Adj. % Chg.*	-9%	4%	-13%	-9%	-7%	-25%

*Inflation adjustment done using state and local government price deflator.

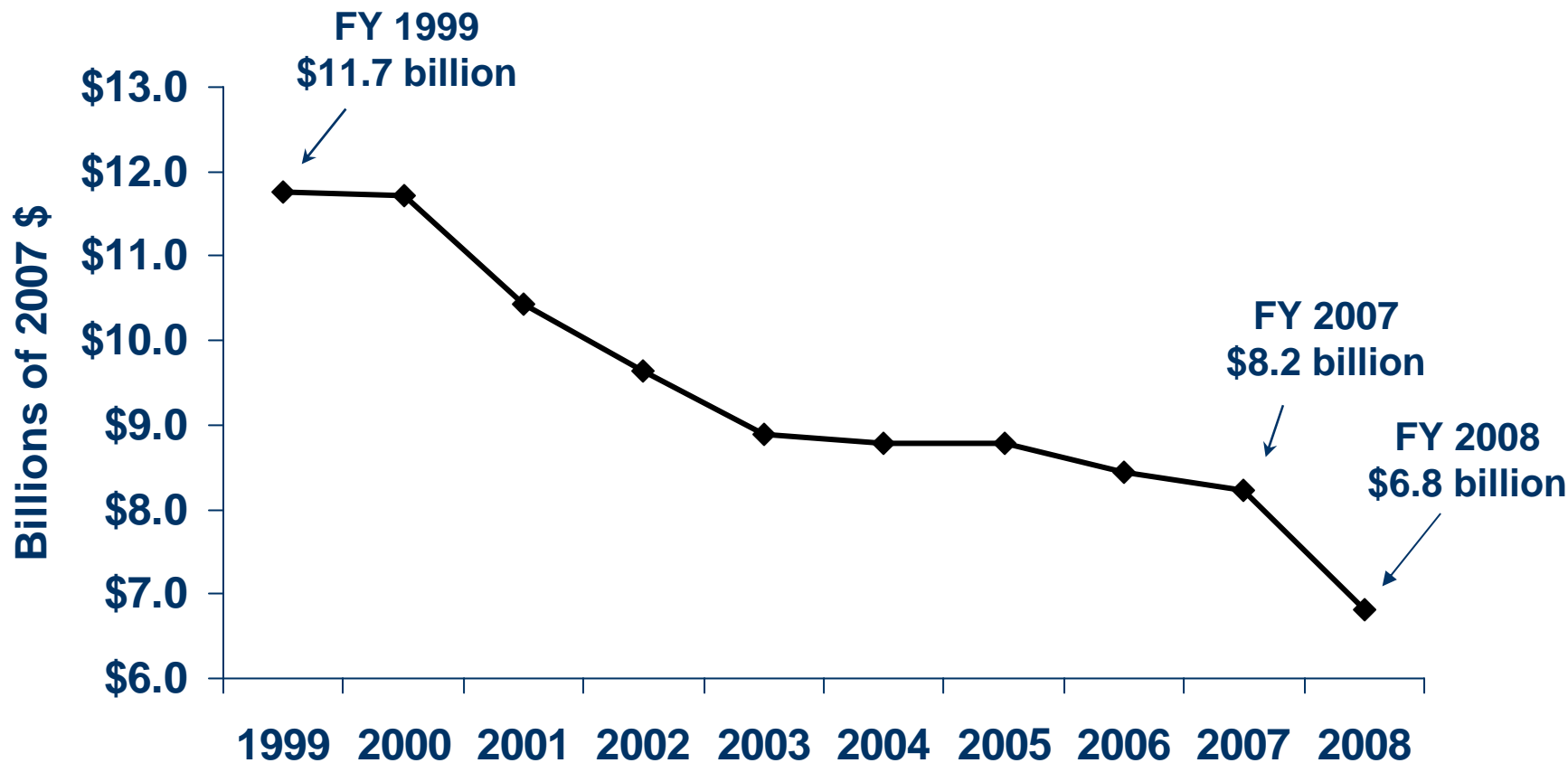
Source: *State Budget Update, Jan 2007*, and *Various Appropriation Reports*, Senate Fiscal Agency

Nominal General Fund Net Revenue in 2007 Less Than in 1996



Note: Totals exclude transfers and savings from adjusting statutory revenue sharing payments to local governments. 2008 drops due to SBT repeal.

Inflation Adjusted FY 07 GF-GP Revenues Down 29 Percent Since FY 99



Totals exclude transfers and are adjusted to 2007 dollars using U.S. CPI-U.

Revenue at Extreme Historic Lows

Fiscal Year	Governor	Inflation Adj GF Revenue (2006\$)	% Above 2006
1973	Milliken	\$11,820	43%
1978	Milliken	\$12,129	47%
1989	Blanchard	\$11,649	41%
1999	Engler	\$11,518	39%
2000	Engler	\$11,496	39%
2006	Granholm	\$8,267	

GF-GP Expenditures Fall

Fiscal Year	Actual	FY 2001 Grown by S&L Deflator
2001	\$9,744.4	\$9,744.4
2002	\$9,189.3	\$9,953.8
2003	\$8,830.9	\$10,343.9
2004	\$8,770.1	\$10,734.1
2005	\$8,702.8	\$11,381.2
2006	\$9,056.6	\$12,018.7

State Government is Smaller

<u>Fiscal Year</u>	<u>Governor</u>	<u>Number State Employees</u>	<u>Non-Corrections State Employees</u>	<u>Corrections Employees</u>
1973	Milliken	52,673	50,316	2,357
1978	Milliken	64,456	59,990	4,466
1989	Blanchard	64,560	52,038	12,522
1999	Engler	60,066	43,003	17,063
2000	Engler	61,493	43,841	17,652
2006	Granholm	52,259	35,813	16,446
% Change 1978-2006		-19%	-40%	268%
% Change 2000-2006		-15%	-18%	-7%

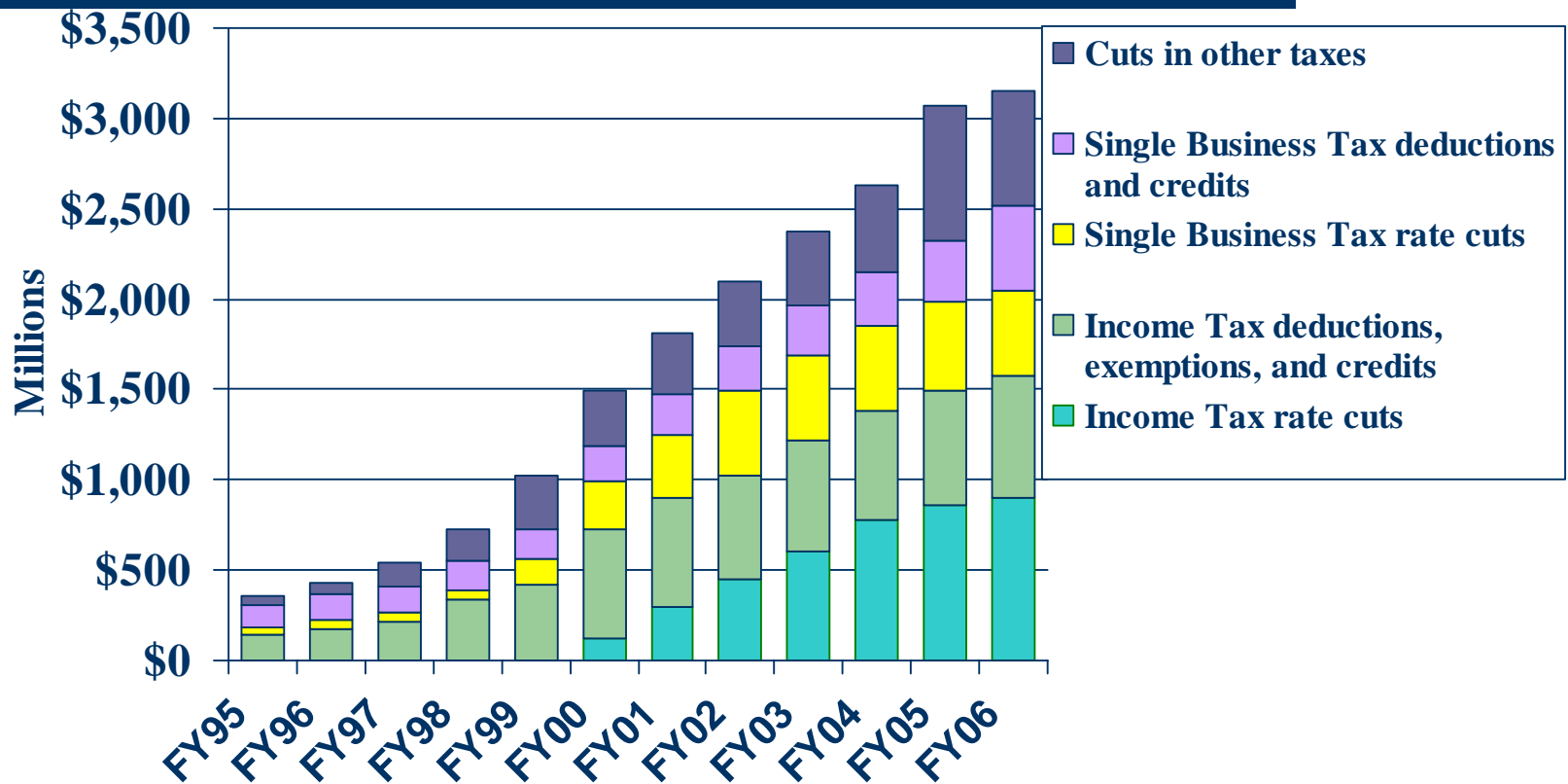
Government Not Large Compared to Other States

State and Local Govt. Employees Per 10,000 of Population		
State		Rank
Ohio	544	27
Minnesota	539	31
Indiana	528	35
Wisconsin	521	37
Illinois	500	43
Michigan	499	44
U.S. Average	538	

State Government is Well Run

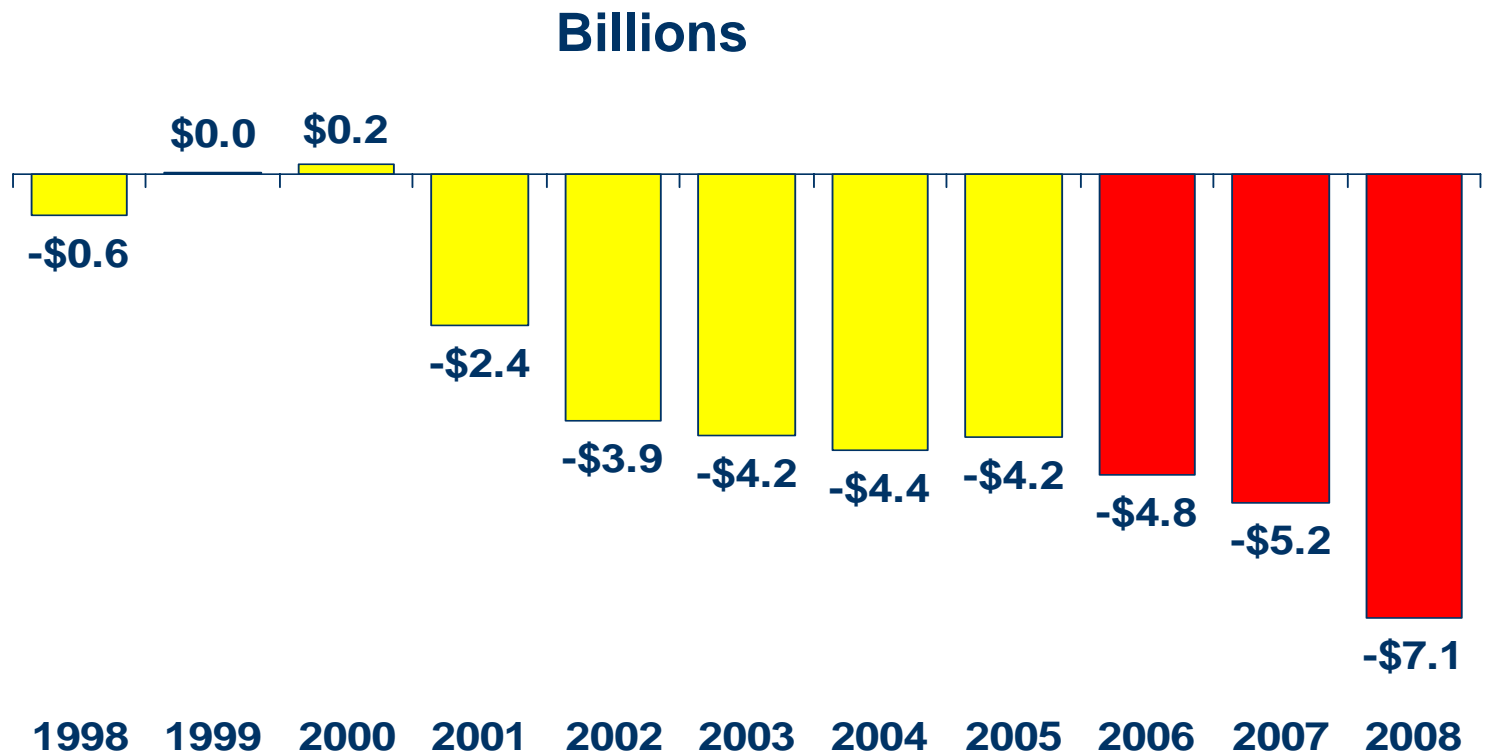
State	Grade	Rank
Virginia	A-	1
Utah	A-	1
Michigan	B+	3
Minnesota	B+	3
Delaware	B+	3
Kentucky	B+	3
Washington	B+	3
Ohio	B	8
Wisconsin	B-	21
Indiana	C+	30
Illinois	C+	30

Tax Cuts Since Proposal A Total \$3.2 Billion in FY 2006



Note: Totals above are tax cuts only and do not include the effects of the gasoline, casino, and cigarette tax increases which generate \$870 million per year

Constitutional Revenue Limit Calculation



January 2007 Consensus

Elements of the Plan

- MBT with changes suggested by business community
- 2% tax on services excluding education and healthcare
- Federally decoupled estate tax applicable to 350 estates a year worth more than \$2 million
- Increase in OTP and \$0.05 cigarette tax increase
- Increase in liquor markup
- Elimination of certain loopholes
- Sales tax break for car buyers based on the value of a car traded in for a new vehicle

Effects of Tax Changes

- Plan will recapture about 1/3 of tax cuts of last decade
- Michigan's business and overall tax burdens will remain below the national average
- The replacement for the SBT will make Michigan a more attractive place for businesses
- Makes Michigan's tax structure more responsive to economic growth
- Allows us to invest in education and healthcare to make Michigan more attractive for businesses and our citizens

Michigan Business Tax

- Tax base consists of sales, assets, and income
- Broad base allows for rate of 0.125 percent on sales and assets – the lowest rate in the country!
- Tax rate on profits just 1.875 percent, well below any other state's corporate income tax rate¹
- Includes special features for small businesses
- Provides personal property tax relief

1. Alaska and Arkansas have corporate rates that start at 1 percent but have substantially higher top corporate rates.

Changes to the MBT

- Change definition of financial organizations
- Subtract sales of intangible assets from gross receipts
- Eliminate double taxation of corporate partnerships
- Subtract inter-company sales among affiliates from gross receipts
- Exclude foreign assets and tax deferred assets from the base
- Provide a credit for high paying jobs provided at corporate headquarters

MBT Cuts State's Major Business Tax

- Headquarters credit reduces taxes by \$240 million
- Other changes reduce the MBT by an additional \$240 million so the MBT raises \$480 million less than the SBT would
- \$578 Million tax cut for Michigan businesses
- \$250 million tax cut for small businesses
- 111,000 firms pay less MBT than SBT while 33,000 firms pay more

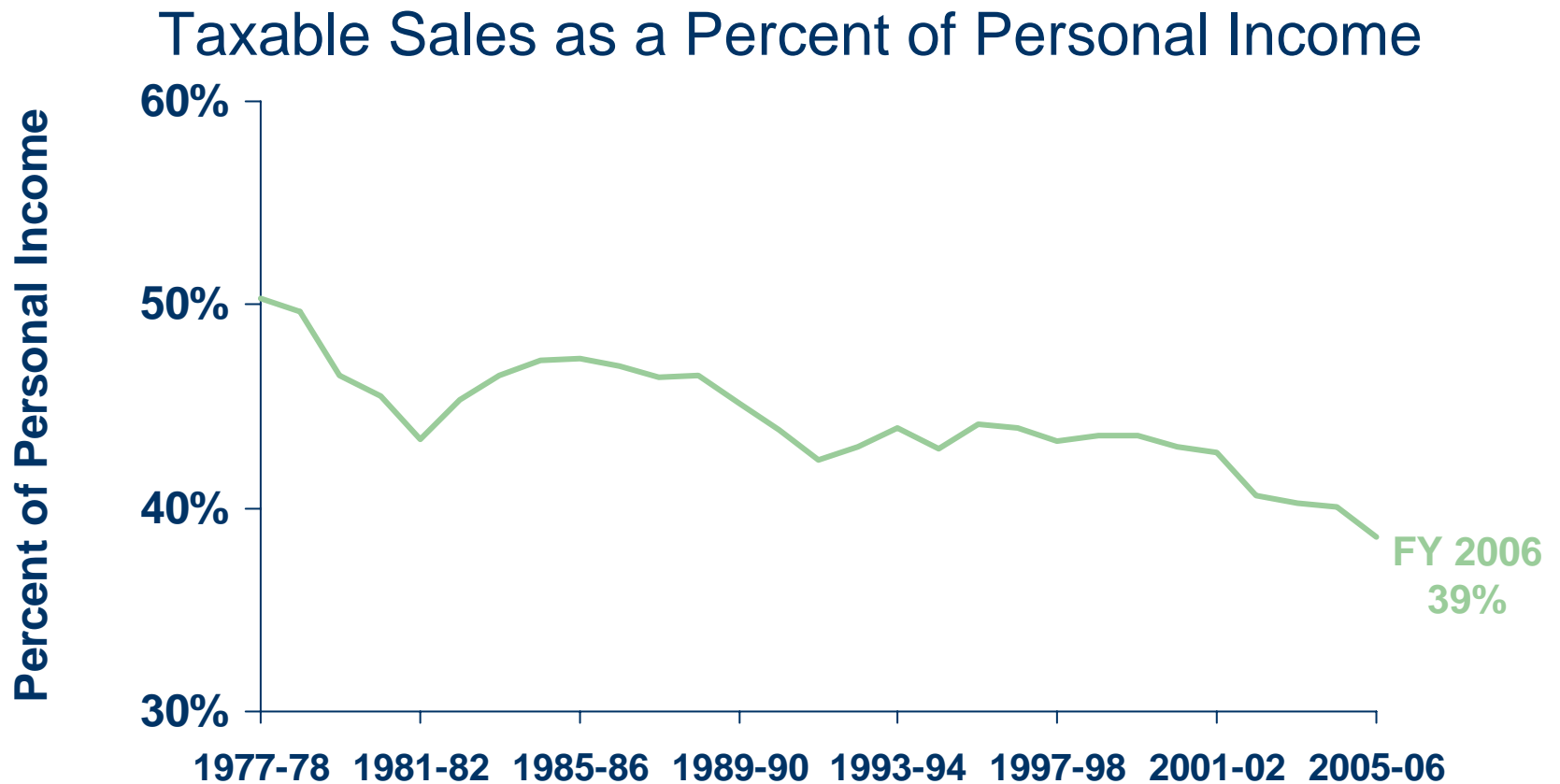
Personal Property Tax Relief

- Industrial and commercial personal property will be exempt from the 6 mill state education tax and the 18 mill local school operating tax
- The exemption amounts to an average reduction of 46 percent in personal property taxes
- This change does not affect city, township, or county taxes
- Cut lowers personal property taxes by over \$600 million per year

MBT Cuts for Service Businesses

<u>Service Category</u>	<u>% Tax Reduction</u>	<u>% Paying Less</u>
Accounting Services	-50.8%	93.6%
Legal Services	-66.0%	91.3%
Auto Repair Shops	-63.3%	91.4%
Dry Cleaning	-67.4%	89.9%
Engineering/Architectural	-69.8%	91.3%
Total For All Services	-33.2%	83.0%

Sales Tax Share Declining



State Taxation of Services

- Based on a survey by the Federation of Tax Administrators, Michigan currently taxes 26 out of 168 services
- Michigan ranks 39th highest
- On average, states tax 55 services, more than twice as many as Michigan

State Taxation of Services

State	Number of Services Taxed	Rank
Hawaii	160	1
Washington	157	2
New Mexico	156	3
South Dakota	146	4
Delaware	143	5
Wisconsin	74	11
Ohio	68	16
Minnesota	67	17
Michigan (current law)	26	39
Indiana	23	41
Illinois	17	46

Taxing Services

- Proposing a 2 cent tax on services beginning June 1
- Tax base would include professional entertainment, repair and maintenance services, construction services, legal and accounting, and personal care

Exempt Services

- Some services excluded from tax are
 - Healthcare and education
 - Daycare
 - Religious services
 - Sales to non-profits and governments
 - Services provided for agricultural production
 - High school and college sports admissions
 - Museums, historical sites, zoos, and parks
 - Scientific research and development

Many States Tax Services

These Items are Currently Exempt in Michigan

<u>Service</u>	<u>Number of States Taxing</u>
Landscaping	21
Auto Repair	23
Dry Cleaning	24
Health Clubs	22
Installation*	24
Shoe repair	21

*Installation by seller of item, 19 states tax installation by non-sellers

Many States Tax Admissions and Amusements

These categories would be taxable under the service tax
Number of states taxing in parentheses

- Professional sports (22)
- Pari-mutuel racing (29)
- Bowling alleys (28)
- Circuses/fairs (35)
- Cultural events
(theater, concerts) (34)
- Amusement parks (38)
- Cable/satellite TV (26)
- Billiard parlors (28)
- Membership dues (24)

Examples

1. \$25 pedicure – cost with tax \$25.50
2. \$35 greens fees for golf – cost with tax \$35.70
3. \$100 theater tickets – cost with tax \$102.00
4. \$250 labor charge on repair bill – cost with tax \$255.00
5. \$5,000 consulting bill – cost with tax \$5,100

Sales Tax on the Difference

- Allows trade-in allowance to be deducted from price of new car when calculating sales tax starting October 1
- Change would bring Michigan's practice in line with most other states
- Tax reduction of \$180 million per year

Taxpayer Example

	Income = \$57,300	
	Basic Example	More Complex Example
Est. Sales Tax	\$1,087	\$1,087
Est. New Service Tax & Loopholes	\$69	\$69
Total Tax Including Services	\$1,156	\$1,156
Estimated Tax Increase	\$69	\$69
\$25k Home Renovation - Sales Tax	NA	\$623
\$25k Home Renovation - Service tax	NA	\$292
Total Estimated Tax Increase	\$69	\$361
Vehicle Trade-in (\$10,550 avg)	NA	-633
Total Estimated Tax Increase	\$69	-\$272

Estate Tax Decoupling

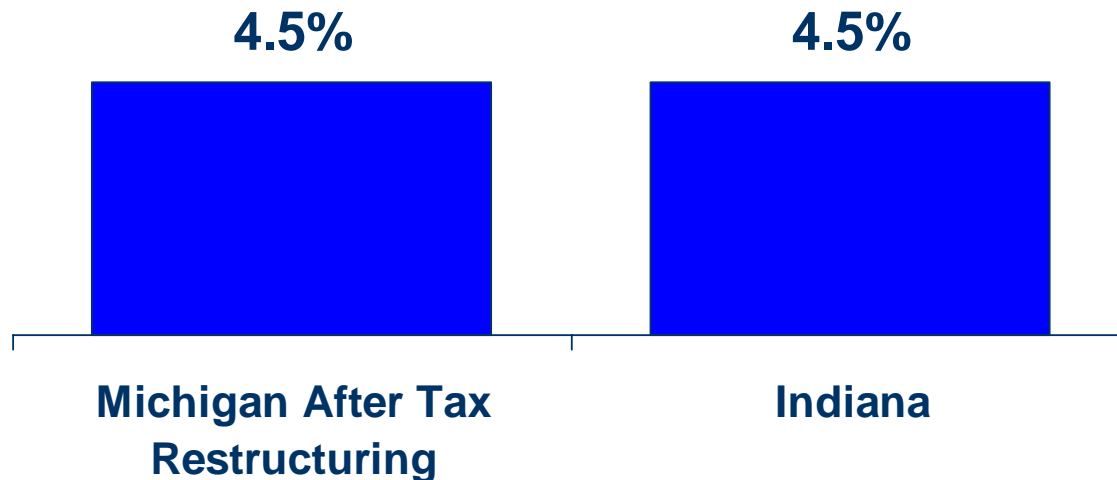
- Federal law changes made in 2001 effectively ended Michigan's estate tax
- "Decouple" proposal would base Michigan's tax on 2001 federal law
- 18 states and the District of Columbia have decoupled
- No tax for estates valued less than \$2 million
- Assets attributable to family owned businesses and farms exempt
- Effective rates after federal deductibility close to 5%

Tax Burden After Changes

- Michigan state and local business taxes as a percent of GSP will be 4.5% compared to U.S. average of 4.8%
- Michigan's total state and local tax burden will be 10.66% of personal income compared to a national average of 10.75%

Michigan's Business Tax Burden Will Be the Same as Indiana's

Effective Tax Rates as Pct
Of Private Sector GSP



Source: COST Analysis, with Michigan after restructuring calculated
By the Michigan Department of Treasury

Overall Balance Sheet

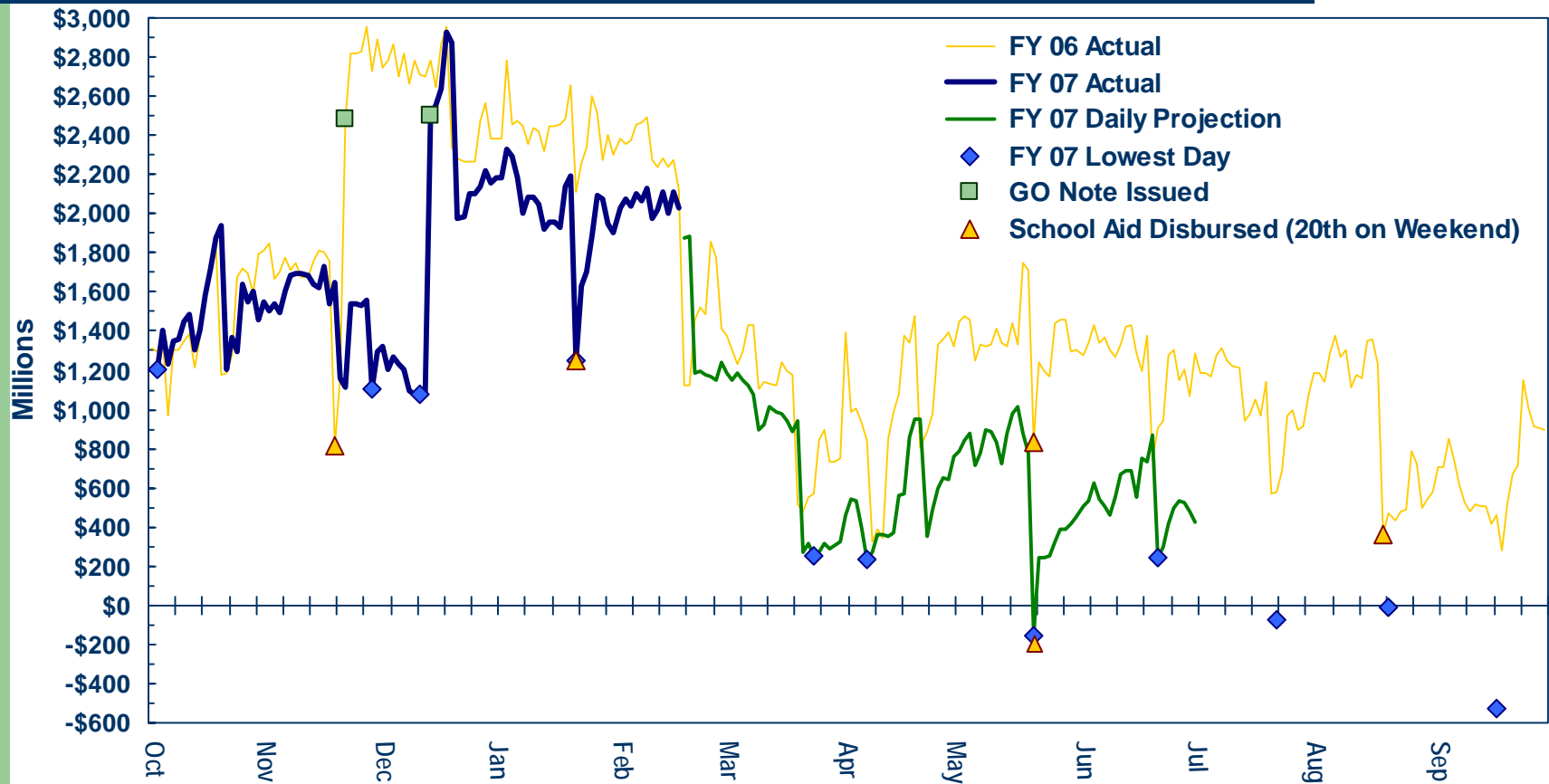
	<u>CY 2007</u>	<u>CY 2008</u>	<u>CY 2009</u>	<u>CY 2010</u>
Net Effect SBT Replacement	\$0.0	(\$457.7)	(\$468.6)	(\$467.4)
Service Tax	\$845.5	\$1,484.6	\$1,529.2	\$1,575.0
Loopholes & Other Increases	\$95.1	\$190.2	\$194.3	\$198.6
Estate Tax	\$29.8	\$120.1	\$134.9	\$138.9
Sales Tax on Difference	(\$43.8)	(\$176.3)	(\$181.6)	(\$187.0)
Net Effect Restructuring	\$926.6	\$1,160.9	\$1,208.2	\$1,258.1
EITC	\$0.0	\$0.0	(\$127.9)	(\$283.6)
Net Revenue with EITC	\$926.6	\$1,160.9	\$1,080.3	\$974.5

Timing Issues

- The SBT replacement must be enacted rapidly to remove uncertainty for businesses to allow them to prepare
- The service tax needs to be enacted quickly to avoid mid-year cuts to education and vital services

Manageable Cash

FY 06 Actual & FY 07 Actual to Date and Projected



Includes: GO Note proceeds of \$1.3 billion note borrowing, the GO Note repayment in September, and projected 21st Century Jobs Fund Disbursements. **Does not include:** proposed Tax Restructuring revenue.

Manageable Cash Overview

FYE	Cash	Interest	G.O. Note	Manageable	CREDIT RATING		
30-Sep	GF/SAF/BSF	Income (Expense)	Borrowing	Common Cash	S&P	Moody's	Fitch
2000	\$ 2,896.0	\$ 137.3		\$ 4,892.1	AAA	Aa1	AA+
2001	2,085.7	115.0		3,868.2	AAA	Aaa	AA+
2002	599.9	5.7		2,376.2	AAA	Aaa	AA+
2003	(490.1)	(17.2)	\$ 1,248.0	1,425.7	AAA	Aaa	AA+
2004	(897.6)	(23.5)	1,300.0	1,179.6	AA+	Aa1	AA+
2005	(854.4)	(52.4)	1,275.0	1,018.9	AA	Aa2	AA
2006	(1,298.5)	(58.5)	1,299.5	860.8	AA	Aa2	AA
2007			1,306.9		AA *	Aa2 *	AA-

(in Millions)

*negative outlook

- The cash balance has decreased by \$4.2 billion over the past 6 years. The BSF has been depleted.
- The cost of doing business has increased by \$216 million. The General Fund now pays interest instead of earning interest.
- External borrowing has been needed every year since 2003 to finance cash flow needs.
- The State's credit rating has decreased along with the cash deterioration. Note: Letter of Credit needed for Dec note borrowing.